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pensions & investments

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Funds stayed dry during market dive

A Pensions & Investments Round-Up

NEW YORK—Cool heads among pension fund managers may have saved the stock market from a historic "crash of '79."

That appears to be the lesson of the October 8 through 12 market dive when the Dow Jones Industrial Average plunged 58 points and a record 253.7 million shares were traded.

Not that some institutions weren't in there selling along with the individuals—banks, insurance companies and investment counselors all were involved—but, according to leading brokers, the institutions, unlike the individuals, were not reacting in panic.

And some of the largest institutions were either net buyers for the week, or were neutral—buying as much as they sold—providing a stabilizing influence in an unstable situation.

Most experts agree that individuals played a larger part in the market decline than the institutions, and that the individuals were reacting to several factors—the sudden action of the Federal Reserve system to control the money supply directly, the approaching 50th Anniversary of the "crash of 1929" which brought back unpleasant memories, the prospect of paying 16% or 17% on margin purchases, and the fact that the market had reacted calmly to much bad news earlier in the year, including sharply higher interest rates.

Some institutions reacted to the Federal Reserve action on the money supply front, but there was some disagreement as to the extent of institutional selling.

Lou Eisenberg, partner at Goldman Sachs, said the selling was broad-based, but "individuals were definitely a factor."

Mr. Eisenberg said that it was apparent from the block trade volume—which was very large—that institutions were also a factor.

However, he said, the institutional trading generally was well thought out, although there were some "anxious sellers."

Dave Williams, chairman and chief investment officer at Alliance Capital Management, however, said that executives of Donaldson, Lufkin, Jenrette, Alliance's parent brokerage concern, reported the institutions bought about as much as they sold during the hectic week.

Mr. Williams said it was "within the realm of possibility" for non-institutional investors to account for the greater part of the 253.7 million shares traded in the week.

He said there were investment groups listed as "other," such as risk arbitrageurs at brokerage houses, which could account for much of the selling.

"Every brokerage house has a huge risk arbitrage department," he said. They are huge generators of volume. They are not listed as institutional."

Mike Hallick, vp at Cantor Fitzgerald in Beverly Hills, Ca., said that while there were many institutions selling, they did not sell to the extent that individuals did.

And, he said, it was mostly investment advisers who were doing the selling. The banks and insurance companies were not in the forefront during the frenetic exchange.

"Investment advisers do not have to go through as long and drawn out a committee procedure, and they take action more quickly than banks," he said.

According to Charles Thomas, vp at Loomis Sayles, Boston, "if it hadn't been for the institutions and their ideas about valuations in the stock market being low, the market would have been a lot worse."

He pointed out that there had been tremendous buying on October 10, when the market went from being down about 25 points to being down only eight at the close.

"In 1929 there were no institutional buyers," he noted.

As for Loomis Sayles' posture during the collapse: "We idled," Mr. Thomas said. The firm is fairly heavily invested with only

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The Week That Was on Wall Street

October 8-12	Dow at Close	+/−	Volume (shares)
Monday	884.04	−13.57	32,610,000
Tuesday	857.59	−26.45	55,560,000
Wednesday ..	849.32	− 8.27	81,620,000
Thursday	844.62	− 4.70	47,530,000
Friday	839.99	− 5.63	36,390,000
Totals:		**−58.62**	**253,710,000**

—Pensions & Investments, 10/22/79

Chrysler worst-case scenario

Premiums could jump 370%

By Les Stern

WASHINGTON—If Chrysler Corp. collapses, the Pension Benefit Guaranty Corp. (PBGC) may have to demand a 370% increase in its single employer premiums, according to a top PBGC official testifying before a Senate committee.

Presently, the PBGC per-participant rate is $2.60; a rate that would be shoved to as high as $9.60 per-participant in the event Chrysler collapses and its pension funds terminate, according to PBGC officials.

At the same hearing, Banking, Housing and Urban Affairs Committee chairman Sen. William Proxmire (D-Wi.) said he would rather use federal funds to pay off the unfunded liability than give the automaker a loan, even though the liabilities may be greater than the loan.

Appearing during the second of three days of Oversight hearings on Chrysler's troubles, PBGC executive director Robert Nagle said in a worst case situation, a rough estimate is that PBGC would have to raise premiums $6 to $7 above the current $2.60 per participant rate.

Under this scenario, the potential liability to the PBGC would be between $950 million and $1.1 billion. This assumes that PBGC would not be able to collect any of the up to 30% of Chrysler's net worth it would be entitled to under ERISA's termination liability provisions.

"The long-term financial integrity of the PBGC single employer insurance program would be endangered if such liabilities were to be incurred," Mr. Nagle warned.

He said the $1,043 billion in Chrysler pension fund assets the PBGC would receive would pay benefits for six-and-one-half years, and existing PBGC assets could carry payments for about another year, so there is no immediate crisis in meeting cash flow requirements.

Mr. Nagle added that the PBGC hopes any premium increase would be temporary, although the $6 to $7 increase does not take into account the possible collapse of any other major corporation.

After the hearing, Mr. Nagle said since it is too early to make any definite statements, he could not say whether a premium increase would be phased in.

Mr. Nagle's testimony served as the catalyst for a spirited and sometimes heated debate between Sen. Proxmire, an outspoken opponent of federal aid to the automaker, and Sen. Donald Riegle (D-Mi.), an equally outspoken advocate for aid.

Sen. Proxmire said he would rather have the federal government pay the pension liability than set a precedent and provide federal loan guarantees to the country's 10th largest company. Most of the talk of federal aid has focused on amounts between $500 million and $750 million.

Even though the potential liability to the PBGC is greater than the amount being discussed for loans, Sen. Proxmire labeled Mr. Nagle's worst-case picture as "not realistic at all."

He said the picture the PBGC chief painted assumes that all Chrysler's plants would shut down; the firm would not go through a bankruptcy reorganization and none of its divisions would be sold. Under questioning by Sen. Proxmire, Mr. Nagle said he had no way of knowing how unrealistic PBGC projections are because the PBGC does not have enough information and probably will not until Chrysler plans begin terminating.

Sen. Riegle sardonically told Sen. Proxmire that it was a "generous comment" for him to say the government should pay off the unfunded pension liabilities.

"If we're prepared to write out a check that size, it makes sense to provide the

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Inside

Recollections of 12 who were there

3 It wasn't your usual 50th Anniversary "celebration," but the conversation was more fascinating than the lunch. Early this month Drexel Burnham Lambert brought together 12 gentlemen who were working on Wall Street that infamous day—October 29, 1929. Sitting in to overhear the recollections—and black humor—was Associate Editor Clare Minick. The group had hardly pushed away from the table, by the way, when . . . well, see our lead story above.

Social Security: An unbeatable what?

8 The new Secretary of HEW, Patricia Harris, in what may be her first public statement on the soundness of Social Security, has called the system "an unbeatable investment in the future." An editorial on our opinion page suggests that Ms. Harris should brush up on chain letters and Ponzi schemes.

MPT is still alive and very well

20 With the October massacre on Wall Street—1979 version—still fresh in most minds, the big money has more pressing things to be concerned about than Modern Portfolio Theory (MPT), right? Wrong. MPT is still very much alive and well, thank you. In fact, a couple of new funds—those of K Mart and Allied Chemical—have joined a half dozen other large corporate fund sponsors in implementing MPT strategies.

More logs for international fires

29 Two Features section contributors throw a couple of more logs on the fire that continues to envelope the question of whether or not U.S.-domiciled pension assets should be invested in foreign securities markets. You guessed it: one log is well-seasoned and burns fiercely for the concept; the other is still green and throws off a lot of smoke.

Milwaukee banks go public—page 12

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SIA: Capital needs may prompt more mergers of security firms

NEW YORK—On the heels of the Paine Webber-Blythe Eastman Dillon proposed merger, the Securities Industry Association (SIA) has released a study predicting the merger trend will continue.

The study notes that merger activity in the securities industry has been linked to securities firms' desire to diversify, both in terms of customer base and types of services and also to the need for additional capital.

However, the study showed that large firms do not necessarily achieve higher returns (or profitability) than small firms. The SIA concludes from its analysis of profits and costs of both large and small firms that small and medium sized firms will continue to compete effectively with the larger firms.

Counter to many predictions, the SIA is not predicting that the securities industry will consist eventually of a handful of giant firms.

From 1973 to 1978 the securities industry suffered a number of poor market environments, periods of high interest rates, and importantly, the onset of negotiated commission rates in May, 1975, the study noted.

As institutional investors became increasingly more dominant in the markets, securities firms began to commit capital to execute trades as principals, rather than agents, which calls for more capital.

Though need for capital has increased, the SIA study shows that supply has not kept pace.

In 1978 total capital in the securities industry averaged $4.1 billion, up only 8% from the 1973 average of $3.8 billion.

The study says that in contrast, the industry's total assets increased from $22.6 billion in 1973 to $53.9 billion in 1978. Over the same time, the ratio of total assets to equity capital increased from 8.9 to 15.7.

"The poor earnings performance in the industry in the 1970s has made it difficult to build up capital by reinvesting earnings—at the same time it makes equity capital from outside sources prohibitively expensive," says the study.

Increasing concentration in the securities industry has resulted in a striking decline in the number of New York Stock Exchange firms doing business with the public. From 1973 to 1978 the number shrank to 366 from 444.

Over the same time the largest 25 firms increased their share of industry gross revenues from 47.8% to 70.7%. Their share of commission business jumped to 64.8% from 42.3% over the same time.

Merger activity has resulted in concentration of capital among the top 25 firms, according to the study. For instance, in 1973, 47.4% of capital in the securities industry was held by the top 25 firms. By 1978 the percentage was 66.8%.

The SIA study analyzed return on equity for firms in the industry to see if there was a correlation between size of firm and return on equity (see chart).

The top 10 firms achieved the highest rate of return on equity (ROE) in only one year, 1974. Further, the study says, the top 10 firms do not seem to have any less volatility in the ROE despite greater diversification.

Small New York City (NYC) firms had the highest ROE in 1978 which is tied to their reliance on commissions (1978 was a record year for volume).

The study said: "The ROE figures indicates that firm size is not a key determinant of performance. Firms having similar business mixes are more likely to have comparable returns on equity even though the size of the firms may vary."

The study also looked at profit margins for the various firms (see chart). Margins are a major determinant of ROE, according to the study, and also reflect the business mix of the various firms.

The top 10 firms had the highest profit margin in four of the six years, 1973 through 1978. Small NYC firms showed the highest margins in 1978.

The study notes that "the more capital intensive lines of business tend to have higher profit margins (or in poor years, negative margins). The years 1975 and 1976, when the top 10 firms' margins were at their height were years favoring the more capital intensive product lines with falling interest rates."

On the basis of analyzing firms' profitability, plus their expenses, the SIA concludes that smaller firms can compete with larger firms.

"While the increase in concentration and Mayday's contribution toward that increase are both undeniable, it is difficult to conclude from the data set forth in this study that the securities industry is inexorably moving toward complete domination by a few diversified giants." ■

Securities Firms
After-Tax Return on Equity 1973-1978

	1973	1974	1975	1976	1977	1978
Top 10	1.6 %	3.9%	16.6%	17.9%	7.3%	9.8%
Second 15	1.6	2.2	17.0	17.6	5.8	9.7
All Other	9.6	2.9	17.1	18.6	7.0	12.6
Small NYC	1.8	2.7	14.0	14.7	6.5	20.7
Large NYC	2.6	1.2	21.7	18.6	8.2	13.3
Small Regionals	4.5	1.9	16.4	16.4	6.3	12.6
Medium Regionals	1.2	(5.0)	15.4	15.6	6.0	11.6
Large Regionals	3.5	(0.8)	17.5	17.7	9.6	13.6

Source: Securities Industry Association

Profit Margins—By Size Category

	1973	1974	1975	1976	1977	1978
Top 10	1.1%	2.3%	8.3%	8.7%	3.9%	3.9%
Second 15	0.9	1.0	6.0	6.1	2.3	2.9
All Other	0.4	1.5	6.8	6.9	2.9	5.1
Small NYC	1.0	1.5	6.8	6.7	2.9	6.0
Large NYC	1.3	0.5	6.8	6.1	3.1	4.2
Small Regionals	2.8	1.0	6.5	5.9	3.0	5.1
Medium Regionals	0.6	(2.2)	4.9	5.1	2.3	4.2
Large Regionals	1.6	0.3	5.6	5.7	3.3	4.0

Source: Securities Industry Association

FEATURES

International investing: Is the time right?

U.S. is still the best

By Steven C. Leuthold

BRACE YOURSELVES, all ye offshore-based investment managers traveling to these shores in search of opportunity among U.S. pension investors. There is a devil's advocate up in Minneapolis who, before the chill of winter sets in, would like to get a few burning thoughts on the subject off his chest.

Not that I wish to alienate my peers overseas in a truly multinational world. However, there's been enough written and reported on within these pages that's been positive; it's time for those of us with feet of clay on the subject to tread into the waters and cloud them.

This is not going to be a chauvinistic red, white and blue nationalistic diatribe. I have no bumper sticker saying "Made in America by Americans" on my car (even though it is a Volkswagen). I *do* believe in international diversification. I *do* believe there are many fine companies outside the United States. I *do* believe that at least some other countries have better long-term economic growth potential than the U.S. But why start a significant foreign investment program now?

So you really believe the Japanese stock market at 19 times earnings, is more attractive than the U.S. market at 7 times earnings? Energy problems? Japan has them in spades.

Do you really believe stocks in Singapore or Hong Kong, now on average selling at about two times book value, really are better values than U.S. stocks (now on average selling at 1.1 times book)?

Do you really believe stocks in Italy, Norway, Canada, Switzerland and Austria, all on average yielding less than 4%, are on a total return basis, really that much more attractive than U.S. equities (yielding close to 6%)?

When examining the stock markets around the world, we find by most available value comparators, book value ratios, pe ratios, yield and price to cash earnings' ratios, very few nations where equities are currently as cheap as they are in the U.S. Outside of the Netherlands, Denmark and maybe Sweden, statistically at least, the most undervalued stock market is right here in the good old U.S.A.

Capital International, based in Geneva, Switzerland, provides comparative data for 18 stock markets around the world. The table with this is partially based on this data. Of course, accounting practices vary from nation to nation, but still the market-by-market comparisons of book value ratios, earnings' ratios and yields can be combined to establish some overall relative value benchmarks. Even taking into consideration the individual variabilities from nation to nation, the U.S. market comes out as one of the most undervalued stock markets in the entire world.

Most Attractive Market

Now, if one factors in the additional U.S. market advantages of high liquidity (a very large plus), full disclosure, available research coverage and transaction simplicity (to say nothing of trying to learn how to pronounce the names of those foreign stocks) the U.S. should be viewed as the most attractive market in the world.

- Consider also that, even though the U.S. is in an energy dilemma, so are most of the other nations surveyed, except the United Kingdom and Norway. Actually, the U.S. is less dependent on oil imports than say Japan or Germany.
- Consider that the U.S. economy has already started to cool off, while in many nations this is yet to come. From a stock market standpoint, this is viewed as a positive because stock markets typically discount ahead, turning down before the economy turns down.
- Consider that inflation is now rapidly accelerating in other nations around the world, from Germany to Austria. U.S. inflation momentum on the other hand, at least according to some of our indicators, may have peaked or at least be very close to maximum levels.
- Consider that even though we may view our political situation with Carter as unstable, there are few if any nations around the

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The U.S. Stock Market vs. the World

Total Mkt Capitalization (billions)	Country	Approximate p/e	Value Index[1]	1978 Performance	1979 Performance thru July	Performance 1/1/77 thru 7/79
$24[2]	Netherlands	5.5x	200	− 1%	− 9%	−11%
4	Denmark	5.5x	300	− 8%	+ 4%	− 8%
10	Sweden	7.5x	300	+11%	− 2%	−10%
900	**United States**	**7.5x**	**350**	**− 1%**	**+ 4%**	**−16%**
150	United Kingdom	7.0x	350	− 3%	− 3%	+30%
16	Spain	8.0x	350	−12%	+11%	−31%
75	Germany	9.0x	450	+ 4%	− 8%	+ 4%
50	France	14.5x	500	+43%	+26%	+73%
13	Belgium	16.0x	500	+ 9%	+ 9%	+12%
28	Australia	9.5x	550	+14%	+ 9%	+37%
90	Canada	9.5x	600	+26%	+21%	+56%
42	Switzerland	13.0x	650	− 4%	+ 8%	+10%
14	Hong Kong	12.0x	650	+25%	+26%	+39%
12	Italy	17.0x	750	+23%	+20%	+11%
2	Austraia	16.0x	750	− 1%	− 2%	− 8%
300	Japan	19.0x	750	+24%	+ 4%	+26%
2	Norway	22.0x	800	− 2%	+85%	+36%
12	Singapore	17.0x	850	+32%	+10%	+51%
1750	**The world**	**9.1x**	**550**	**+16%**	**+ 5%**	**+13%**

Notes: [1] Combined book value ratios, cash flow ratios, p/e ratios, yields and liquidity measures; [2] 40% Royal Dutch. Parts of this table are extrapolated from data published by Capital International, Geneva. While some value measures are not comparable on a country-by-country basis because of accounting variances, this combined value index is thought to be meaningful.

No time like now

By Chris Nowakowski

Many pension fund executives who are convinced of the risk and return benefits of international diversification are concerned that now might not be the right time to invest overseas.

Aren't the Dow and the dollar overdue to bounce back? They ask. And anyway, aren't we the last bastion of private enterprise?

From a U.S. point of view, the acid test of timing is to examine the historic impact of overseas investment results on a domestic portfolio.

How sensitive is that impact to the question of timing? Analyses of actual performance records show a consistency of risk and return benefits that our simulation studies suggested.

Nonetheless skeptics abound, particularly with respect to the likelihood that overseas markets will continue to outperform our market.

In fact, it seems these skeptics have been saying the same thing every year for the past two decades. And maybe they are finally right.

Since the U.S. market hasn't been in first place once in the past 20 years, it may really be our turn now. If nothing else, these long-term skeptics have the law of averages going for them.

But there are a number of other important factors in looking at the question of timing the startup of an international diversification program.

- Our relative economic strength is waning. A quick glance at world economic series attests to that; so does the fact that we now produce some 40% of the world's GNP, down from 50% just 10 years ago. Productivity, savings ratios, and R&D expenditures indicate much the same trend. Capital expenditures by U.S. companies in overseas markets continue to grow faster than they do at home. These trends can change—but, and this is a strong but, not overnight.
- An Ibbotson/Sinquefield, or risk-premium, analysis of overseas financial markets also suggests that stock market returns abroad may continue to exceed the Standard & Poor's 500.
- As prudent pension managers, we would never feel comfortable making 100% bets on our favorite industry, nor even on our favorite asset class. Why should we feel comfortable making 100% bets on our favorite market and currency—even if it is in the U.S.? Is it prudent to pretend that anyone's crystal ball is good enough to place 100% bets on a single favorite market? Can we afford to be that right—or that wrong?

Mr. Nowakowski is president of InterSec Research Corp., New York, a consulting firm specializing in international investment management.

The bottom line answer to the question of timing international diversification lies in the phrase itself: diversification. Is today the wrong time to maximize expected returns at an acceptable given level of risk? I doubt it.

In fact, asking whether today is the right time to be overseas is like asking whether today is the right time to be in bonds.

The answer to both questions must always be "yes"—to one extent or another. And, we must answer in the affirmative *even* if our expected overseas (or bond) return is below that of our expected return in the U.S. equity market.

Diversification into international equities, as into domestic bonds (or cash), brings with it the strong and continuing probability of more stable (and higher) pension fund returns.

And this means lower and more stable corporate contributions. That's what keeps pension funds happy and money managers employed.

In the past nine months some
30 pension funds have made
40 international appointments
totaling $400 million.
This brings the total overseas
exposure of ERISA funds to
$1 billion.

Chris Nowakowski

The immense significance of return stability is illustrated in the table.

Impact of Variability of Returns on Terminal Wealth

	Starting Dollars	Year 1	Year 2	Avg. Ann. Return	Ending Dollars
Manager A	100	+30%	−30%	0	91
Manager B	100	+10%	−10%	0	99

Note that the two managers have the same average annual return. However, Manager B, simply because his returns have fallen in a narrower band, is $8.00 richer than Manager A. (Note, too, that neither manager is back to $100.)

Furthermore, recent evidence points to the increasing power of international diversification as a risk reducing component of the asset allocation process.

Correlations are falling and so are standard deviations. International diversification can be as powerful a tool as cash in setting overall portfolio risk levels. Yet it does not carry the implicit opportunity cost of domestic market timing.

So much for the question of timing, but is it really prudent to invest abroad with ERISA assets?

The recent regulations put out by the Department of Labor certainly suggest that international investing is prudent. So does the fact that there are 60-odd participants today. These pension fund managers like to sleep at home, not in jail. And so do their lawyers.

In fact, let me reverse the prudency question. Fifty percent of world market capitali-

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U.S. still best . . .

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world with more built-in political stability and many where conditions are far worse.

• Consider the U.S. business environment and taxes. Again, It could be better in the U.S. but this nation remains as one of the most attractive, least socialistic environments for capitalism, if not the most attractive, in the entire world.

• Consider that one of these days the dollar may make a real comeback. Many foreign international experts view the dollar as the most undervalued currency in the world, and a strong dollar or at least real stabilization may not be far away. If the dollar firms, U.S. investors in foreign markets are losers, just as foreign investors have been losers in the U.S. market over the last five years or so as the dollar sagged.

• Consider that while U.S. pension funds have been busily looking elsewhere for investment opportunities, the foreign investors have been looking increasingly toward the U.S. In the last four months it is estimated that foreigners have accumulated on balance about $800 million of publicly-traded stocks. Even more dramatic is the level of direct foreign investment in U.S. real estate, acquisitions of U.S. businesses and construction or acquisition of U.S. plants by foreign interests.

Examine our comparative table of 18 stock markets aroung the world. Applying our combined value factor index, only three markets appear to be as cheap as the U.S. And those three (Holland, Denmark and Sweden) are relatively small, limited liquidity markets. The United Kingdom does appear to be relatively close to the U.S. on a value basis, but look at the two-and-one-half year market performance, the London market is up 30%, the U.S., measured by the DJIA, down 16%.

It's true that over approximately the 30 months there have been some big and profitable moves in foreign markets (France up 73%, Canada up 56%, Singapore up 51%, Hong Kong and Australia up over 35%, and Japan and the United Kingdom measuring 25% and 30% respectively). The U.S., on the other other hand, is down 16% measured by the DJIA and down 5% measured by the S&P 500. An old stock market axiom is: "Buy them when they hate them and sell them when they love them." While this was originally said about individual stocks, it probably makes sense for individual stock markets as well.

With all this, why are U.S. pension funds so aggressively pursuing foreign investment?

• Is it primarily because many foreign markets have outperformed the U.S. market in the last few years; another case of the chronic pension problem of chasing past performance?

• Is it because in sophisticated pension circles it has recently become an in vogue thing to have a portion of your funds invested abroad?

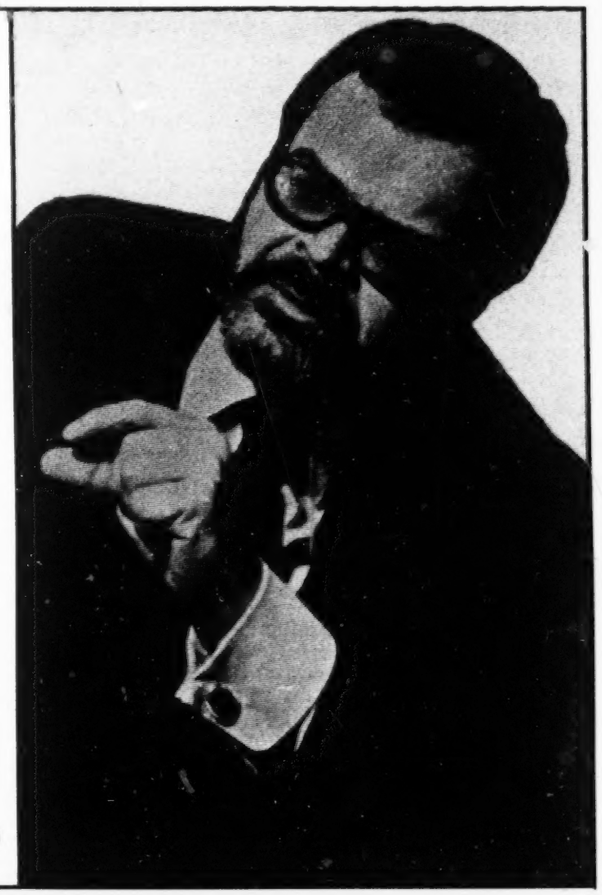
• Or is it simply because the grass looks greener on the other side?

A lot of sheep that think that way get cut up pretty bad in barbed wire fences.

This is not to say that foreign investing is by its very nature poor policy. Instead, the real question is, for heavens sake, why now? "When," as Russell Conwell so effectively said in a classic lecture series he traveled around this country giving early in this century, "there are acres of diamonds (opportunties) in our own backyard." ■

This is not to say that foreign investing is by its very nature poor policy for corporate pension funds. Instead, the real question is, for heavens sake, why not?

Steven C. Leuthold



The Liquidity Report

	SEPT. 1979	AUG. 1979	JUNE 1979	DEC. 1978	1-MO. % Change	3-MO. % Change	9-MO. % Change
DJIA	7294.9	8028.9	6129.6	*	−9.2%	+19.0%	*
NYSE	746.9	786.9	643.2	395.6	−5.1	+16.1	+ 88.8%
ASE	56.0	51.0	50.8	24.6	+9.8	+10.2	+127.6
AMIVEST All listed	498.2	523.3	429.3	259.8	−4.8	+16.0	+ 91.7

*Comparatives statistics not available due to change in components.
Source: Amivest Corp.

Stock liquidity gains 16% in latest quarter

NEW YORK—The average common stock listed on the New York and American Stock Exchanges gained 16% in liquidity during the third quarter of 1979 and 91.7% for the first nine months of the year, according to the monthly Liquidity Report.

Published by Amivest Corp., an international diversified investment service organization, the Liquidity Report is a monthly service which provides liquidity and marketability data for all common stocks listed on the NYSE and ASE.

The largest gain in the last quarter in liquidity for the four major indices tracked by the firm was scored by the Dow Jones Industrials (+19%), while for the nine-month period Amex led with a gain of 127.6%. ■